96-45

EX PARTE OR LATE FILED

ORIGINAL

RECEIVED

MAY - 8 2003

Federal Communications Commission
Office of the Secretary

From: Precursor Group - Scott Cleland
To: Mike Powell
Date: Tue, Apr 22, 2003 5:43 PM
Subject: SBC Is Likely the Most Competitively Vulnerable Big Cap Telecom of 2003

Summary: Precursor continues to caution investors that SBC is likely the most vulnerable big cap telecom of 2003 because it is more on the wrong side of regulatory and competitive change than any of the Bells. SBC will likely indicate a tough first quarter and faces a deteriorating operating environment in 03. We expect guidance for 03 to be lowered sometime this year, as well as additional capex and job cuts, because SBC clearly was surprised that the FCC did not rein in UNE-P in the Triennial Review. While all of the Bells will suffer this year from the FCCs reinvigoration of UNE-P, SBC is by far the most vulnerable to resale competitionwhile VZ, with its greater scale and integration, is best able to defend against it. SBC faces the worst case of telecommoditization, i.e., rising competitive intensity that reduces profits as Bells and long distance (LD) carriers enter each others markets. Specifically, in at least two-thirds of its territory (the former Ameritech region and CA), SBC confronts severely negative regulatory environments and competitive dynamics with some of the lowest UNE-P rates in the country. In the Ameritech region, SBC is defenseless against heavy local line losses due to regulatory roadblocks into LD service. Recent SBC LD entry and lower UNE-P rates in CA have raised the competitive intensity in that state as telecom providers cut prices and compete with service bundles. SBC may be forced to acquire (most likely an LD carrier or LD assets) while it still has the currency, which would further weigh down the stock. (The full research can be accessed by viewing the attached PDF file.)

Registered Clients visit Precursor Research Archives. Forgotten your password? Email websupport@precursorgroup.com or call Daniel Pfenenger at (202) 828-7823.

Scott C. Cleland, CEO
The Precursor Group
202) 828-7800 phone
scleland@precursorgroup.com
Member NASD/SIPC/Investorside Research Association

Precursor Group®
Investorside℠ Research

"The Leader in Anticipating Change"®

901 15th Street, N.W. Suite 370 Washington, D.C. 20005-2348
Phone 202.828.7800 | Fax 202.828.7801 | www.precursorgroup.com

Scott C. Cleland
Patrick S. Brogan
Jamie S. Mendelson
April 22, 2003

SBC Is Likely the Most Competitively Vulnerable Big Cap Telecom of 2003

(Part Five in a Telecommoditization Series)

Summary: Precursor continues to caution investors that **SBC is likely the most vulnerable big cap telecom of 2003 because it is more on the wrong side of regulatory and competitive change than any of the Bells.** SBC will likely indicate a tough first quarter and faces a deteriorating operating environment in '03. We expect guidance for '03 to be lowered sometime this year, as well as additional capex and job cuts, because SBC clearly was surprised that the FCC did not rein in UNE-P in the Triennial Review. While all of the Bells will suffer this year from the FCC's reinvigoration of UNE-P, **SBC is by far the most vulnerable to resale competition**—while VZ, with its greater scale and integration, is best able to defend against it. SBC faces the worst case of "telecommoditization," i.e., rising competitive intensity that reduces profits as Bells and long distance (LD) carriers enter each other's markets. Specifically, in *at least two-thirds* of its territory (the former Ameritech region and CA), SBC confronts severely negative regulatory environments and competitive dynamics with some of the lowest UNE-P rates in the country. **In the Ameritech region, SBC is defenseless against heavy local line losses due to regulatory roadblocks into LD service.** Recent SBC LD entry and lower UNE-P rates in CA have raised the competitive intensity in that state as telecom providers cut prices and compete with service bundles. SBC may be forced to acquire (most likely an LD carrier or LD assets) while it still has the currency, which would further weigh down the stock.

SBC: Accelerating Competitive Intensity in at Least Two-Thirds of Its Territory. **(A) Ameritech Region: A Gaping Wound Caused by a Regulatory Anomaly.** The Ameritech region (MI, OH, IL, WI, and IN), which comprises over one-third of SBC's lines, is a huge negative regulatory anomaly. Unlike VZ and BLS, who have been approved for region-wide LD, SBC can't fight back against UNE-P losses in the Ameritech states with a competitive local and LD bundle. On average, the Ameritech region has the lowest UNE rates in the country—a roughly 61% discount which is 17% higher than the Bell average of 52%. Precursor believes it is unlikely that most of these states will end UNE-P after the FCC-mandated nine-month review process. The low UNE rates are generating huge UNE-P losses—SBC MI has already lost 31% of the local market. AT&T is "ramping" up its UNE-P local entry in IL and IN. This local share loss is all "profit hemorrhage" as SBC cannot staunch the bleeding from this gaping regulatory wound with a competing local-LD package. With the recent withdrawal of its LD application in Michigan, SBC is unlikely to enter the Michigan LD market until ~4Q03. Entry into the remaining Ameritech states will likely be in at the very end of '03 and into '04. As a result, the Ameritech region becomes a deeper and deeper hole for SBC to dig out of once it gets LD approval. Moreover, LD access may come too late to completely salvage profits, as SBC will likely have to cut prices further below UNE-P rates to win back customers. **(B) CA: A Competitive "Race to the Bottom."** In CA (SBC's most important state with one-third of its lines), SBC gained regulatory approval to offer LD at the very end of '02 accompanied, however, by 32% cut in the average CA UNE-P rate last year. SBC has just completed its first full quarter in the CA LD market (it has ~1.3m lines, about 7%-8% of its total CA lines) and has gained lines about par for a Bell's first quarter of LD. However, LD revenue gains will likely be offset by a hyper competitive "race to the bottom" as SBC is cutting prices to offset growing UNE-P losses.

Why SBC Has a More Difficult Future Than the Other Bells. (See attached chart.) **(A) SBC Is Currently In a Deeper Competitive Hole.** Compared to the other Bells, SBC has suffered the greatest line loss from UNE-P and other competition. Cumulative wholesale lines (i.e., those leased to competitors such as UNE-P, unbundled loops, and resale), as a percent of 4Q02 retail lines were 14.7% for SBC compared to 10.5% for VZ, 10.4% for BLS, and 6.6% for Q. Estimated dropped lines, which represent a complete loss of revenue, over the last two years as a percent of 4Q02 retail lines were 7.7% for SBC compared to 6.4% for VZ, 6.1% for BLS, and 7.4% for Q. SBC has outpaced all of the Bells in quarterly retail line loss each of the last eight quarters, and year over year retail line loss for '02 was 8.3% for SBC compared with 5.0% for VZ, 6.1% for BLS, and 5.3% for Q. **(B) SBC Has Less Leverage to Dig Out.** VZ is ahead of SBC in LD market penetration. BLS and Q are rapidly catching up, while SBC's hands are tied in the Ameritech states (38% of its lines). Both BLS's and VZ's wireless subs comprise a greater portion of retail lines than SBC. Finally, where SBC has excelled, DSL penetration is too low to make a difference, and 2nd lines leave SBC potentially more vulnerable to line loss. **(C) Divergence Is Likely to Continue.** Finally, **SBC is facing a more difficult regulatory and competitive environment than the other Bells.** UNE-P rates are worse for SBC than any other Bell. On average, the UNE-P discount per line was 55% for SBC (61% for Ameritech and 57% for CA), compared with the Bell average of 52% (Note: UNE rate data are from WVPSC-CAD 1/1/03, weighted using FCC ARMIS '02 lines, VZ GTE properties not included in averages). While WorldCom has entered local markets in the 48 lower states, T has targeted its efforts in the most profitable states. T is *currently* offering local service in a bundle in states representing 80% of SBC's lines (TX, CA, MI, OH, IL, IN) compared with 47% of VZ lines (NY, NJ, DC, MA, and ~4.5m former GTE lines in CA), 17% of BLS lines (GA), and 0% of Q lines. * * * * *

Why SBC Is the Most Vulnerable Bell to "Telecommoditization"

Line Losses Have Been Digging SBC into a Deeper Hole Than the Other Bells